Steve Leimberg's [Estate Planning](#) Email Newsletter - Archive Message #2068

Date: 21-Feb-13
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Alan Gassman & Christopher Denicolo: Defective Grantor Trusts Are Not Black Holes**

"We do not believe that toggling off grantor trust status constitutes an income recognition event. We have never heard of this tax on 'toggling off' and have found no authority to indicate how or why it would be imposed. Do not sell your clients short by not offering to allow them to engage in defective grantor trust planning."

We close this week with commentary by **Alan Gassman** and **Christopher Denicolo** that addresses a number of important of issues raised by the use of defective grantor trusts.

Alan S. Gassman, J.D., LL.M. practices law in Clearwater, Florida. Each year he publishes numerous articles in publications such as BNA Tax & Accounting, Estate Planning, Trusts and Estates, The Journal of Asset Protection, and Steve Leimberg's Asset Protection Planning Newsletters. Mr. Gassman is a fellow of the American Bar Foundation, a member of the Executive Council of the Tax Section of the Florida Bar, and has been quoted on many occasions in publications such as The Wall Street Journal, Forbes Magazine, Medical Economics, Modern [Healthcare](#), and Florida Trend magazine. He is an author, along with Kenneth Crotty and Christopher Denicolo, of the BNA Tax & Accounting book Estate Tax Planning in 2011 and 2012. He is the senior partner at **Gassman Law Associates, P.A.** in Clearwater, Florida, which he founded in 1987. His email address is agassman@gassmanpa.com

Christopher J. Denicolo, J.D., LL.M. is an associate at the Clearwater, Florida law firm of **Gassman, Bates & Associates, P.A**., where he practices in the areas of [estate tax](#) and trust planning, taxation, physician representation, and corporate and business law.

Here is their commentary:

EXECUTIVE SUMMARY:

In **LISI** Estate Planning Newsletter #2035, renowned and respected estate tax professor and practitioner **Jerry Hesch** cautioned that practitioners should not automatically assume that clients should prudently place a large portion of their assets into irrevocable defective grantor trusts because of a concern that the obligation to pay income tax on income earned by such trusts could cause a loss of significant assets beyond what the client and the practitioner might otherwise expect.

Professor Hesch also cautioned that "toggling off" disregarded grantor trust status (the obligation of the grantor to pay income taxes on trust income) could be considered a taxable event, based upon the theory that the grantor would be relieved of indebtedness and thus would receive "income from the discharge of indebtedness" under Section 61(a)(12) of the Internal Revenue Code. We have never heard of this tax on "toggling off" and have found no authority to indicate how or why it would be imposed.

FACTS:

We agree with Professor Hesch that numbers and financial projections should be run for many clients to show the possible effect of a defective grantor trust arrangement, and that in many situations full funding by use of the client's entire $5,120,000 gift allowance may not be appropriate. We also agree with Professor Hesch's analysis of the significant impact of the "burn" caused by the client being responsible for income taxes associated with the grantor trust's income.

On the other hand, Professor Hesch's commentary did not include some points that we believe should be considered by advisors and their clients in making decisions concerning these types of arrangements.

COMMENT:

1. Professor Hesch indicates that the trustee of the defective grantor trust should have the authority to invest in whatever assets are deemed appropriate within reason, and these assets can include

tax-free municipal bonds and mutual funds or equities that pay very low dividend rates, and thus cause the incurrence of very low income tax amounts relative to overall value. In addition, Professor Hesch also alludes to the ability of a trustee to invest in life insurance and annuity contracts that can completely avoid or defer taxable income, although the internal costs of such arrangements must be considered.

However, Professor Hesch's illustration assumes a 5.25% rate of return on average each year that generates ordinary income for the portfolio of a defective grantor trust, and does not take into account that trusts normally have a significant amount of capital gains that are taxed at a lower level (especially trusts holding investment assets, such as the trust in Professor Hesch's illustration).

If a 60% equity and 40% bond portfolio was invested in one or more tax-efficient funds then the expectation might be for only a 1% to 2% ordinary income rate and a 5% to 6% capital gain, based upon the income reporting that flows through from the fund. For example, the Vanguard Explorer Fund Investment recently reported taxable income to its investors of only .12% as ordinary income and 2.92% as capital gains for the period beginning 10/31/2011 and ending 10/31/2012, although the increase in value of the fund during that same period of time was 16.28%. A trust investing in this fund for this year would report a 2.92% capital gain and only .12% as ordinary income notwithstanding the 16.28% rate of return. The excess growth would be recognized as capital gains when the mutual fund is sold.

Further, if the grantor trust provides the grantor with the power to substitute assets of the trust for assets of equal value, then the grantor could swap non-income producing assets or tax-free municipal bonds for the income-producing assets of the trust without recognizing gain or income. This could effectively eliminate the "burn" of grantor trust status at any such time (including as frequently) that the grantor wishes, so long as the grantor has individual assets of equivalent value to the assets that he or she wishes to swap. While the grantor would still be responsible for the income tax associated with the income-producing assets, the grantor would be able to use the income from

the asset itself to pay such tax liability.

Therefore the ability of the trustee to change the investment strategy and the ability of the grantor to swap the assets of the trust should not be understated as effective tools to reduce (or even eliminate) any deleterious impact that the "burn" has on depleting the grantor's estate.

2. If a defective grantor trust did have assets that pay a high rate of return, these assets could be sold to the grantor for fair market value in exchange for a promissory note, which according to Professor Hesch's prior writings could be at or slightly above the applicable federal rate.

As the result of such a situation, the growth of such assets in, and the excess income above the applicable federal rate would go directly into the grantor's pocket, and could be used to pay income taxes and the interest owed to the defective grantor trust.

In the year 2012, according to Professor Hesch's illustration, the value of gifts before discount is $13,333,333 and yield $700,000 of income, resulting in $292,950 of income tax.

Assuming a 2% applicable federal rate that would apply to a note owed by the grantor to this trust, $13,333,333 multiplied by 2% is $266,667 that the grantor would owe the trust at the end of the year. If the grantor earns $700,000 on the assets purchased from the trust, and pays income tax of $292,950 related to such income, then he or she still has $13,473,716 left after paying the trust its 2% interest payment of $266,667.

The above example is an extreme example that would cause the grantor's estate to increase, which is counter-intuitive to the primary purpose for the grantor making the gift. However, it can be used to illustrate the possibility utilizing the strategy of the grantor purchasing assets from the grantor trust for a note at some point in the future when the grantor's estate has been reduced significantly, and the grantor is more concerned with the having funds for living expenses and other personal uses.

3. If the trust is formed in a creditor protection jurisdiction, the

grantor can be a discretionary beneficiary or an "addable" beneficiary, and the trust can still not be included in his or her estate by the reasoning and result of Private Letter Ruling 200944002.

If a planner is concerned about Professor Hesch's observations, why not form the defective grantor trust in Nevada, Delaware, Alaska, or another creditor protection jurisdiction and make the grantor a discretionary beneficiary? If there is a current concern that the IRS might change its position, notwithstanding that it is well-founded in estate tax law, the grantor could be removed as a beneficiary by appointed trust protectors more than three (3) years before death in order to avoid an estate tax inclusion situation under Internal Revenue Code Section 2035.

We typically provide in our documents that the grantor would not be able to receive any benefit or other distribution unless or until his or her net worth comes down to a certain level. We believe that this eliminates the grantor from being considered a potential beneficiary of the trust, and constitutes an act of independent significance that safely keeps the trust from being subject to federal estate tax in the grantor's estate even if the IRS were to change its position on Private Letter Ruling 200944002.

If the "black hole effect" were to occur and a grantor's net worth was brought down to below the level specified in the trust document, then the trustee could simply pay the income tax incurred by the grantor and the problem would be eliminated.

4. The problem would also be avoided by simply having the new irrevocable trust be a complex trust, which would be taxed at its own brackets to the extent that it does not distribute all income. Income could be distributed to the descendants of the grantor, who may be in a lower tax bracket than the grantor, and would have the money received to pay the tax thereon.

   Alternatively, the grantor might choose to fund two separate trusts, one of which is a grantor trust and the other of which is a complex trust, with gifts to make use of all or a portion of his or her $5,120,000 exemption. This will allow the grantor to reduce the possibility that his or her own estate will be reduced too much by

the "burn," while allowing the grantor to take advantage of the positive effects of grantor trusts to some extent. Of course, projections should be run for the client to illustrate the potential consequences of having the two trusts in place and the possible allocation of gifts as between the two trusts.

5. We do not believe that toggling off grantor trust status constitutes an income recognition event. For income tax purposes, income means, "the accession of wealth, clearly realized, and over which the taxpayers have complete dominion" (*Commissioner of Internal Revenue v. Glenshaw Glass,* 348 U.S. 426, 431 (1955)).

   While the discharge of debt will constitute taxable income, the change in a situation where an individual is responsible for an ongoing tax obligation of another entity does not generate income or constitute an income recognition event.

   We have reviewed articles and materials prepared by numerous analysts and experts on toggling off grantor trust status and have found no mention whatsoever of an income taxable event occurring as the result of toggling off grantor trust status unless there are unique circumstances, which might include a situation where there is a large note owed by the to the grantor for low basis assets owned by the trust, or liabilities owed by the trust to third parties which exceed the basis of the trust assets. Another possibility of triggering of income could apply under Internal Revenue Code Section 684 if the trust is a foreign trust. As far as recognizing income simply because the grantor will no longer have to be responsible for tax on trust income, none of the cited articles provide any mention of a possibility of this whatsoever.

   These articles include: **Howard M. Zaritsky**, *Toggling Made Easy—Modifying a Trust to Create a Grantor Trust, Estate Planning*, Volume 36, Number 3, March 2009, 48; **Howard M. Zaritsky**, *The Year in Review: An Estate Planner's Perspective on Recent Tax Developments*, Tax Management Estates, Gifts and Trusts Journal, Volume 36, Number 1, January 2011, 3; *see* Peebles, *Mysteries of the Blinking Trust*, 147 Tr. & Est. 16 (Sept. 2008); BNA , *Portfolio 819-1st Estates, Gifts, and Trusts Portfolios: Trusts*, Section F. Toggling Grantor Trust Powers (2012); **Steven Akers**, *Trustee Selection; Retaining Strings Without Getting Strung-Up,* (2002); *See* Mulligan*, Sale to an*

Intentionally Defective Irrevocable Trust for a Balloon Note - An End Run, 33rd Ann. U. Miami Heckerling Inst. On Est. Planning (1998); Samuel A. Donaldson, *Understanding Grantor Trusts*, 40th Ann. U. Miami Heckerling Inst. On Est. Planning (2006)

The only transactions which these experts and IRS have identified as having the potential for tax avoidance or evasion and are considered "transactions of interest" which occur when a reversionary interest is sold at fair market value so that there is no gain recognized, and the grantor trust status ends. *See* IRS Notice 2007-73, *Transaction of Interest – Toggling Grantor Trust*.

Conclusion

Do not sell your clients short by not offering to allow them to engage in defective grantor trust planning. While there can always be concerns with the possible tax law and how it might be interpreted, we believe that the above considerations properly balance Professor Hesch's well intended and interesting observations and insights.

We fully agree that running the numbers and helping to make sure and that the client and his or her advisors are aware of potential issues and consequences is a good idea. However, it is equally important to inform clients and their advisors of all options available that can assuage potential concerns and reduce the possibility of negative side effects of using a grantor trust.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman
Christopher Denicolo

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